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What to expect in H2?

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- **Key theme: Financial reform outlook** China's Politburo meeting on July 30th 2020 offered important forward guidance on China's medium term growth and macro policy orientation which will focus on developing the "dual circulation" economic structure. The internal circulation and external circulation are interdependent therefore to optimize the "dual circulation" structure, and to ensure the internal and external circulations are both self-reinforcing and mutually reinforcing, synergetic and sustainable, China would need to push forward structural reforms. We discussed China's comprehensive structural reform proposals earlier this year. In this report, we review financial reforms in H1 and present our reform outlook in the coming months.
- **Macro view:**China's V-shaped recovery has largely been completed. We think sectoral divergence will be the main theme in H2. Consumer durable goods spending, notably on autos and smartphones, will likely increase further. PPI will likely come out of deflation, while CPI inflation is unlikely to rise. Asset price overheating risks are emerging, especially in the property sector. Fiscal and monetary policy stances will likely shift from one-sided easing to a more balanced approach.
- **FX view:** We have been constructive on RMB since June and in the 2H of the year, we believe the fundamentals remain ripe for RMB appreciation. One, flow dynamics should remain strong. Two, with RMB becoming more fair valued, the authorities have little reason to halt/slow RMB appreciation. The potential negative tail risk to this is the upcoming US election. However, we see little incentive for either side to pull out of the deal. Hence we retain our downside exposure to USD/CNH via options.
- **Fixed income view:**We believe RMB interest rate normalization will be the key theme in H2 based on assessment of growth recovery, policy shift, asset rotation, supply moderation and global risks. We expect money market rates will re-align with short term OMO rates – 7D reverse repo rate and are likely to be more volatile in H2. We forecast the 10Y CGB yield to range between 2.8-3.4% in H2 when factoring in volatility risk and we expect offshore inflows to accelerate in H2. We expect credit risk to remain stable in H2.

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Key theme: Financial reform outlook

China's Politburo meeting on July 30th 2020 offered important forward guidance on China's medium term growth and macro policy orientation which will focus on developing the "dual circulation" economic structure – internal (domestic) circulation and external (global) circulation. Internal circulation seeks to boost domestic productivity to meet domestic demand, while external circulation aims to meet global/external demand via globalization and global supply chain. The internal circulation and external circulation are interdependent therefore to optimize the "dual circulation" structure, and to ensure the internal and external circulations are both self-reinforcing and mutually reinforcing, synergetic and sustainable, China would need to push forward on structural reforms. We discussed China's comprehensive structural reform proposals earlier this year. In this report, we review financial reforms in H1 and present our reform outlook in the coming months.

At the beginning of 2020, China planned to deepen financial supply side reforms in an effort to modernize its domestic financial system and domestic capital market; however, the outbreak of COVID19 pandemic made China prioritize pandemic control and economic stimulus in the first half of this year, and pushed the financial reform agenda to a later day. Now with the pandemic condition stabilizing and economic growth recovering, we expect China to implement financial reforms at a faster pace in H2 than in H1.

This year, China has deepened financial institution reforms and financial market reforms with the objectives of (a) opening up the financial service sector; (b) addressing financial risks and improving financial stability; and (c) improving capital market efficiency in capital allocation. We focus our discussion on six key areas of reforms - financial opening up reform; financial stability reforms, RMB interest rate reforms, RMB exchange rate reforms, market infrastructure reforms and fintech reform.

Financial opening up

Financial service sector fully opened- At the 2019 Summer Davos Forum, Premier Li announced that China will move forward the timeline of opening up the financial service sector by abolishing foreign equity ownership limits, from 2021 to 2020. On January 1st 2020, China abolished foreign ownership limits for futures companies and joint-stock life insurance companies, then on April 1st , China abolished such limits for securities brokers and asset management funds. As of July, seven foreign securities brokers, three foreign asset management funds and one joint stock life insurance company set up solely-owned or majority-owned financial service business in China.

On August 5th, the CBIRC announced the "Three-year action plan to promote high quality growth of property insurance companies", laying out the roadmap of opening up the property insurance sector.

Financial market fully opened: QFII/RQDFII investment quota abolished and investment regulation relaxed- In May, the PBoC and SAFE issued the "Regulations on the Management of Domestic Securities and Futures Investments by Foreign Institutional Investors", clarifying implementation details after abolishing the investment quotas of QFII/RMB QFII. Specifically (a) to adopt registration management for cross border funds flows by QFII/RQFII investors; (b) to consolidate RMB and FX management and allow investors to freely choose the

timing and currency when making inward remittance; (c) to significantly simplify documentation requirements for outward remittance of capital gains by QFII/RQFII; (d) to remove the limit on the number of custodians; (e) to refine FX risk and investment risk management regulation; (f) the PBoC and SAFE are to supervise on both interim and ex-post basis.

Financial regulation reform

New Securities Act took effect on March 1, 2020 - The New Securities Act of the People's Republic of China was passed at the 15th meeting of the 13th National People's Congress Standing Committee on December 28, 2019, and took effect on March 1, 2020. There are fourteen chapters in the New Securities Act, outlining detailed regulations over the offering and trading of securities, takeovers of listed companies, information disclosure and investor protection. Key features of the New Securities Act are (a) establishing registration-based system for equity IPOs and public offerings of corporate bonds; (b) punishing securities regulation violation and crimes in accordance to the law; (c) strengthening investor protection and information disclosure requirements. We believe enacting the New Securities Act is a significant milestone in China's financial market regulation reform in that it upgrades China's legal framework governing the securities market and promotes the development of a standard, transparent, open, robust, vital capital market.

Launching registration based IPOs on the Growth Enterprise Board- On April 27th , the 13th meeting of the Central Committee for Comprehensive Deepening Reform approved the "General Implementation Plan for the Reform of the Growth Enterprise Board and the Pilot Registration System" and the first batch of registration-based IPOs on the Growth Enterprise Board made their debut on August 4th .

Getting ready for registration-based corporate bond offering- On March 1st, the NDRC issued "Notice about the Registration-based Offering of Enterprises Bonds" which outlined steps to implement registration reform and on July 29th , the NDRC and NAFMII jointly released the "Working Rules for the Review of Enterprise Bonds Offerings" which outlined rules of information disclosure requirements by issuers and underwriters and standardize the review procedure of Enterprise Bond offerings, paving the way to implement registration-based offering in the corporate bond market.

Outlook: As most of the regulatory arrangements of registration based reforms have been introduced, we expect to see (a) primary offering of enterprise bonds and corporate bonds under the registration-based system will kick off later this year; (b) after successful launch of registration-based IPOs in the sci-tech innovation board in 2019 and the growth enterprise board in 2020, the Main Board may start registration-based IPOs possibly in late 2020 or 2021.

Financial stability reform

Addressing financial systemic risks is the key task of financial stability reforms and in the aftermath of COVID19, financial risks have been rising due to higher default risks and NPLs. China has carried out three key reforms to improve financial stability so far this year.

Small and medium banks recapitalization- Small business suffered significant liquidity stress and operating challenges due to the COVID19 shock, and small and medium banks face both rising NPLs and higher capital charges as the government promoted credit growth to the SME business. According to the PBoC, there are

currently 4005 SME banks, of which 605 have capital adequacy ratio below the 10.5% regulatory limit and 532 banks are the weakest, although the CAR of China's overall banking sector was 14.5% by the end of Q1 2020. As such, recapitalizing small banks as part of a broader push for small and medium banks reforms has become quite urgent recently. In response to such systemic threat, on July 1st 2020, the State Council at its executive meeting decided to allow local governments to properly use the funding proceeds from local government special project bond issuance to recapitalize small and medium banks by subscribing to convertible bonds (usually 5Y tenor) issued by these banks in accordance with laws and regulations. This is not only to broaden the channels for small and medium banks to supplement capital, but also to promote small and medium banking system reform.

Formalizing regulation over internet financing by commercial banks and cleaning up internet financing platforms/P2P: On July 17th , the CBIRC formalized the regulation over internet financing by implementing the "Temporary Rules over Internet Lending by Commercial Banks". We view the internet financing regulation as a positive step towards developing a regulated and healthy financing market on the internet. Specifically the regulation (a) allows commercial banks to work with third party to offer internet based financing solutions to borrowers; (b) addresses credit risk management, investor protection and efficient monitoring in the use of borrowed funds associated with internet financing; (c) strikes the right balance between servicing the real economy needs for internet based financing and controlling financial risks.

Meanwhile, regulators continued to clam down on P2P financing platforms and both the number of platforms and outstanding financing balances fell sharply in 2020. According to CBIRC, by the end of Q1, the outstanding balance of internet financing fell by 75% from the beginning of 2019, about five thousand P2P financing platforms exited the market, and only about 139 platforms remained in business.

Winding down troubled financial institutions and reforming corporate governance. On July 17th, the CBIRC announced the takeover of four insurance companies and two trust companies for one year (extendable for longer). Six good/strong financial institutions (four insurance companies and two trust companies) formed six teams to work on the restructuring and takeover of the targeted insurers and trust companies. The takeover follows a similar takeover of three small/weak banks by large banks in 2019. In recent years, China began to remove implicit credit guarantee, allowed credit default events to occur and explored market-based solution to wind down financial/credit risks. Since 2019, China has begun to allow for orderly exit of weakest financial institutions through takeover/mergers by large and stronger financial institutions.

After these takeovers, a more critical question for regulators is what lessons to learn from failed financial institutions. In a featured article in "China Finance" in August, ex-PBoC governor Zhou Xiaochuan pointed out that excessive leverage and fraudulent practices are reasons for a number of high profile cases of risky financial institutions which pose financial systemic risks and he stressed the need to deepen corporate governance reform and strengthen corporations regulatory oversight to address such risks. We share his view and believe effective corporate governance is the ultimate solution to effectively managing corporate operational risks and corporate financial leverage risks.

Outlook: We believe the MoF has allocated RMB200bn quota financed by issuing local government special project bonds and the funding proceeds will be used to recapitalize small and medium banks later this year. We expect all existing P2P platforms will exit the internet financing market by the end of 2020. China may tap into deposit insurance scheme to deal with possible takeover/liquidation of troubled financial institutions going forward.

RMB exchange rate management reform

In 2020, RMB exchange rate reforms focused on optimizing the management of cross border FX flows and refining FX regulatory framework. Specific measures include (a) Simplifying cross border payment regulation to facilitate cross border RMB trade and investment (implementing the twelve measures to facilitate RMB cross border flows - for example, simplifying cross border FX payments by micro e-commerce business; allowing foreign enterprises to use their capital injection to invest in domestic equities; removing the FX account opening limits for capital account transactions); (b) accelerating FX reforms in support of developing Shanghai as an international financial centre; of developing the Guangdong-Hong Kong-Macao Greater Bay Area; and of developing Hainan free trade ports; (c) refining the "macro prudential + micro supervision" FX regulation framework.

Outlook: In the second half of this year, we expect RMB exchange rate reforms to be carried out in four key areas: (a) expanding the pilot program of simplifying RMB cross border transactions of trades and investment; (b) relaxing FX regulation over cross border investment by private equity investors; (c) further opening up domestic financial market and consolidating FX regulation by foreign investors in the integrated fixed income market; (d) continuing to refine FX regulations framework to effectively regulate speculative cross border flows.

RMB interest rate reform – Loan Prime Rate reform

On August 17, 2019, the PBoC announced it will deepen lending rate reform by refining the Loan Prime Rate (LPR) market based pricing formation mechanism. The LPRs are linked to China's open market policy rates to ensure policy transmission, and currently refer to the 1Y MLF rate, plus a spread. There are two benchmark tenors available, the 1Y and 5Y LPR rates which are fixed on a monthly basis (on the 20th each month) by taking the arithmetic average of pricing quotations from eighteen commercial banks after taking out the highest and lowest quotes. In July, 1Y and 5Y LPR fixing rates were 3.85% and 4.65%, at 90bps and 170bps above the 1Y MLF rate.

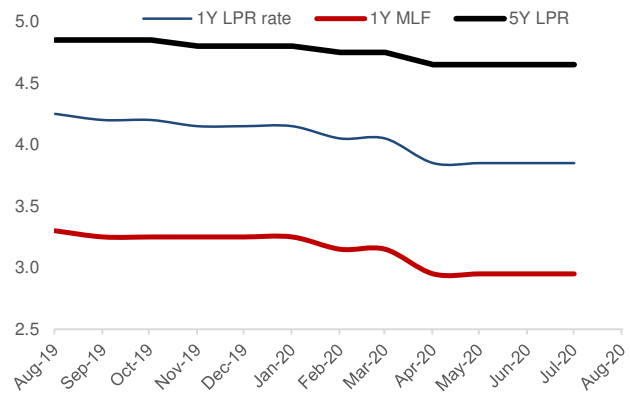
LPR benchmarking of outstanding floating rate mortgage loans will be completed by the end of August. The LPR rates are now the benchmark lending rates for most of China's new bank loans and from March 1st 2020, commercial banks began to work with mortgage borrowers on transferring the outstanding mortgage loans which are floating rate loans based on the previous policy lending rates (to be phased out soon) to LPR based (plus a spread) floating rate mortgage loans. Commercial banks are expected to complete the re-benchmarking exercise by the end of August 2020.

LPR based IRS market started to develop. As LPR rates have established themselves as the benchmark lending rates in the loan market, they are becoming the benchmark rates for bond market pricing – floating rate bonds (corporate bonds or RMBS) are priced with reference to LPRs. Meanwhile LPR linked derivatives market is fledging. Currently both 1Y LPR and 5Y LPR based IRS products are traded in the interbank market and in July, about RMB22bn notional amount of LPR IRS

traded in the market, or 1.3% of the total IRS trading volume in the market.

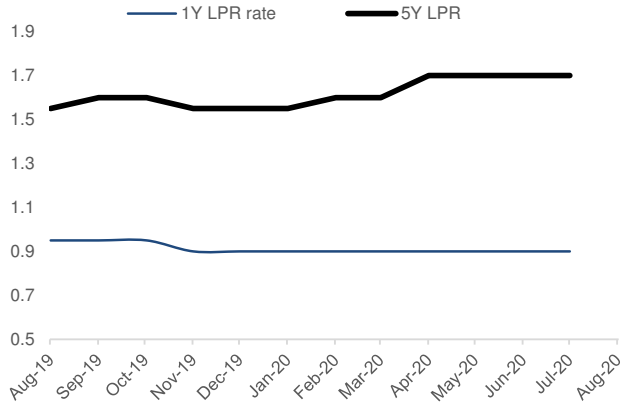
Outlook: After the completion of outstanding mortgage loans re-benchmarking to LPRs in August, we expect LPR reform to focus on (a) commercial banks to improve pricing capacity of LPR in reference to both banks' assets and liabilities, and establish reasonable transmission to banks deposit pricing, money market pricing (interbank borrowing pricing)/Shibor pricing, which will develop the RMB interest rate system from monetary policy rates, to market based lending rates, money market rates, risk free yield curves as well as credit risk pricing; (b) deepening LPR based IRS market to allow for efficient interest risk hedging by investors and borrowers.

Figure 1: LPRs are lending rate benchmarks (%)



Source : Deutsche Bank, Bloomberg Finance LP

Figure 2: Spread to LPR to 1Y MLF rate (%)



Source : Deutsche Bank, Bloomberg Finance LP

Market infrastructure reform

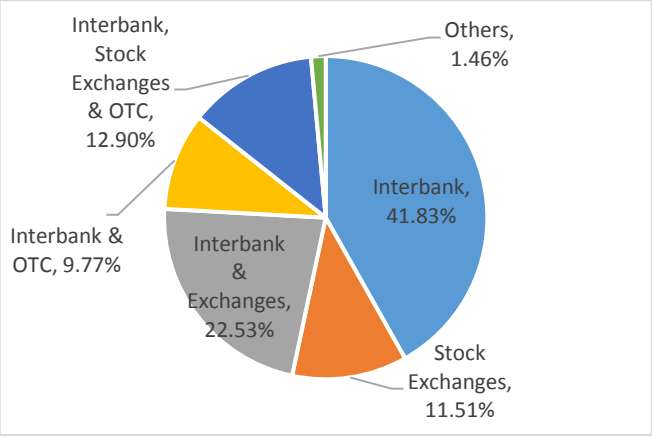
Integrating domestic fixed income market: China's domestic bond market consists of three markets – the largest is the interbank bond market where institutional investors including commercial banks, non-bank financial institutions and foreign investors are active. The second largest is the bond market in the Stock Exchanges, where non-bank financial institutions that are Stock Exchange members and retail investors are active. The OTC market (at the counter of commercial banks) is the smallest and primarily for retail investors to invest in the fixed income market. Out of the RMB107trn outstanding bonds by the end of July, about 42% bonds trade only in the interbank bond market, and 11.5% trade only in the Stock Exchanges. About 22.6% of bonds trade on both the interbank market and the Stock Exchanges, 9.77% of bonds trade on interbank and OTC market, while 12.9% of bonds trade on all three markets. Trading is most active in the interbank market – in the first seven months of this year, about 96.2% of cash bond trading, 73.9% of repo trading and 100% interbank borrowings transacted in the interbank bond market, and the rest in the Stock Exchanges. On average, bond trading volume in interbank bond market was RMB1.1trn/day and bond trading volume in the Stock Exchanges was about RMB43bn/day during the first seven months. Because of market segregation, the interbank and Stock Exchanges market are very different in many aspects: for example, (a) regulators - the central bank regulates the interbank bond market and the CSRC (China Securities Regulatory Commission) regulates the Stock Exchanges: (b) new issue approval and primary offering procedures; (c) bond products – for example, corporate bonds

issued by listed corporates are traded in the Stock Exchanges, while non-listed corporate credit such as enterprise bonds are traded in the interbank bond market; (d) secondary market liquidity; (e) access to the bond futures market – interbank bond market members such as commercial banks and insurance companies were not allowed access to the China Financial Futures Exchange, while most Stock Exchanges members have access to China's bond futures market. In April 2020, five commercial banks were granted approval to trade in bond futures contracts in the China Financial Futures Exchange; (f) settlement/clearing agencies, trading conventions are also different in the interbank bond market and the Stock Exchanges.

On July 17th 2020, The PBoC, the CSRC jointly issued the "Announcement of the PBoC and CSRC ([2020] No. 7)", agreeing to improve interconnections of fixed income market infrastructure between the interbank bond market and bond market in the Stock Exchanges. **The announcement marked the end of the twenty-three years to bond market segregation and we believe this is a key breakthrough towards developing an integrated domestic fixed income market.** We believe developing an integrated fixed income market is an important step for China to modernize its domestic financial market in that (a) it allows for consolidation of market regulators and regulation, currently the PBoC, the CSRC, the CBRIC, the Ministry of Finance and the NAFMII (National Association of Financial Market Institutional Investors) will jointly regulate the domestic bond market and coordinate on bond market regulations; (b) it allows for standardization of primary offering regulation and secondary market trading regulation, repo regulations, trading conventions etc; (c) it improves market liquidity; (d) it reduces transactions costs and allows for more efficient market pricing discovery both in the primary and secondary market; (e) it broadens investors' market access; (f) with greater liquidity and more efficient pricing, domestic bond market will be more efficient in monetary policy transmission, as well as interest rates and credit risk pricing transparency.

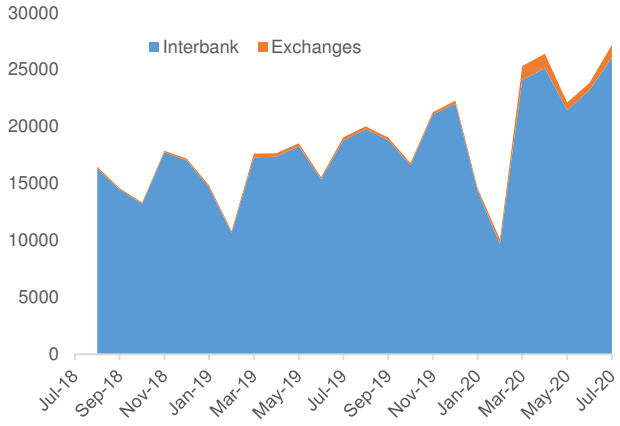
Outlook: We expect to see progress on market infrastructure reform in two areas: (a) details of primary and secondary market regulations consolidation should be announced; (b) further relaxation of bond futures market access: more commercial banks and foreign commercial banks will likely be granted bond futures market access; after CBIRC implements regulations over insurers' trading of financial derivatives (financial derivatives, bond futures, equity index futures), domestic insurers should start to take part in the bond futures market; moreover, access to bond futures by offshore/foreign institutional investors should be relaxed.

Figure 3: Outstanding bonds by markets



Source : Deutsche Bank, Wind

Figure 4: Monthly trading volume (RMBbn)



Source : Deutsche Bank, Wind

Fintech reform

Experimenting Digital Currency pilot program in four cities. On April 17th , China launched the (close-door) experiment of Digital Currency (DCEP) pilot program in Shenzhen, Suzhou, Xiongan, Chengdu. The PBoC stated that DCEP is intended to primarily substitute M0 and that paper money and DCEP will co-exist for a long time. There is very little public information about the DCEP experiment and we think China's DCEP is at the early stage of research and development and there is not yet a firm timetable to formally introduce DCEP.

Outlook: We believe the near term priority in China's Fintech reform is to establish the basic rules and regulatory framework over the Fintech sector and to expand the Fintech pilot programs (for example, industrial financing based on blockchain etc).

In conclusion, we believe China's medium term strategy to develop the "dual circulation" economic structure requires China to re-accelerate structural reforms as growth continues to recover and among all the reforms, financial reforms are the most crucial in driving market efficiency, modernizing domestic financial system and improving financial stability and we look forward to faster implementation of financial reforms in the remainder of 2020.

Economic Outlook: Overheating Risks

Overview

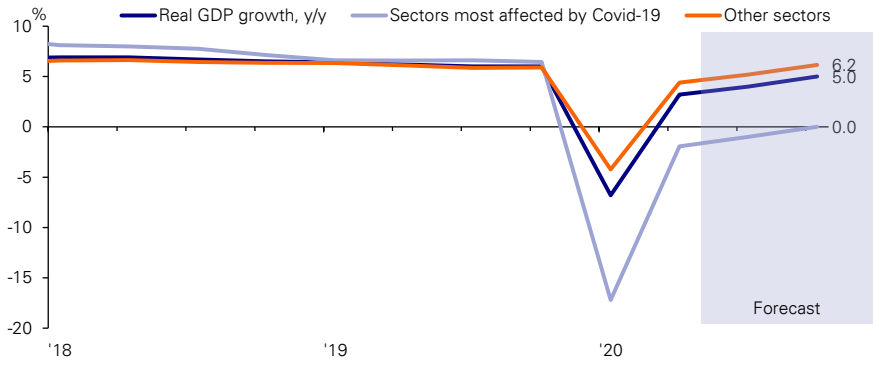
China's V-shaped recovery from Covid-19 is largely complete. China's economy was on track to strengthen in 2020 [1] , but growth was interrupted by the Covid-19 outbreak**.** The economic shock of Covid-19 was unprecedented: real GDP shrank by 11% q/q seasonally adjusted in Q1 2020. The subsequent recovery has been equally strong: real GDP rebound 12% q/q in Q2. In the second half of 2020, we expect the slope of the recovery will flatten; q/q growth will only be sightly higher than potential in H2, while y/y growth will stay below potential.

We think the main theme in H2 and beyond will be a structural divergence across different sectors. Covid-19 has changed consumer spending preferences and business models. The economy is still adjusting to people's behavior change. While some sectors continue to suffer, other sectors are already emerging as winners post Covid-19. Social distancing practices severely reduced in-person services businesses such as hospitality and leisure, but have boosted e-commerce and the digital economy. Long-distance travels have reduced, but short-distance transport have increased, which helps auto demand. Exports of apparel and jewelry are free-falling owing to global lockdowns, but exports of medical supplies and computers have surged. The jobs and income shock has been larger to lower income households and smaller to higher income groups; as a result, high-end consumption has recovered faster.

Slack and bottlenecks will likely happen at the same time in different sectors. Specialized physical and human capital cannot be moved easily from one sector to another. For instance, city traffic is getting more congested than before, while airplanes are still sitting idly on the ground. Such inefficiency in capital and labor allocation will keep aggregate output at below-potential levels. We forecast China's GDP growth will be 5% y/y in Q4 2020, below China's trend growth rate of around 6%. The drag will be largely coming from a few sectors that were hit hard and slow to recover. At the same time, growth in other sectors could achieve or even exceed trend growth in H2 (Figure 1).

1 See our China 2020 Outlook: Bottoming Out.

Figure 5: GDP growth in H2 will likely diverge among different sectors



Source : Deutsche Bank Research, NBS, WIND
Note: "most affected" sectors include wholesale and retail, transport, dining and lodging, and leasing and business services.

Policies have become much more accommodative and will continue to support growth in H2. Fiscal and monetary easing helped China's recovery in H1. Policy stances will unlikely turn sharply in H2, given still below-trend GDP growth and unemployment pressures from labor intensive sectors such as apparel and leisure services. Higher money and credit growth and a large (6% of GDP) fiscal stimulus package will continue to support the economy in H2. Most stimulus measures are broad-based; they will benefit not only those hard-hit sectors but also those already doing well. As such, risks are that some sectors will start to show signs of overheating.

Consumer durable goods spending, notably on autos and smartphones, may rise above trend. Households have cut spending in many areas owing to social distancing, but will likely increase spending on cars and smartphones as they help reduce unnecessary social interactions. Auto replacement cycle and 5G network roll out will also boost demand in H2. Pent-up demand---households saved more than necessary during Covid-19 and may increase spending afterwards---provides additional upside to consumer spending.

PPI inflation will likely rebound while CPI inflation will likely remain subdued. PPI will be supported by government fiscal stimulus as well as strengthening global demand. Meanwhile, Covid-19's asymmetric shock to the job market, which reduces jobs and depress wages for low skilled labor, will likely continue to be disinflationary to consumer prices.

Overheating risks in the property sector. Current macroeconomic environment---below potential GDP growth, large fiscal stimulus and high credit growth---is what historically have led to property market overheating. Property sales and prices are already rising especially in Tier 1 and top Tier 2 cities. The government's changed approach towards the property market has worked well in the past two years, but it remains to be tested whether it will be effective in preventing another round property market overheating.

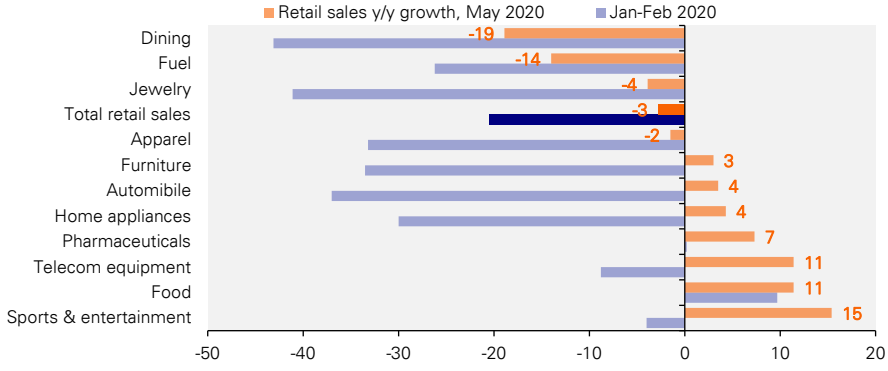
Consumer durables will benefit from spending switching

We expect a return of consumer durables upward cycle in H2. We highlighted in our 2020 Outlook that after two years of slow down, an upward cycle for consumption is expected for 2020, in part driven by a new round of replacement needs for auto and smartphones. It seems that Covid-19 has delayed this upward

cycle but has not stopped it from happening. Indeed, consumer spending has been coming back quickly in recent months.

Consumer behavioral change helps durable goods sales. Despite that Covid-19 has been under control in China for months, the population remains risk averse as localized outbreaks have happened a few times, most recently in Beijing and Hong Kong. Theaters and large public gatherings are still banned. As a result, consumers are getting used to attending less social events and are cutting their related spending. These include not only dining, travel and leisure spending, but also "conspicuous consumption" items such as apparel, bags and jewelry. Consumer durable goods demand, on the contrary, are not affected by social distancing. In fact cars and smartphones are being used more frequently owing to social distancing. As a result, consumers are shifting their spending to these items. This structural shift in spending is evident from recent retail sales breakdown (Figure 2).

Figure 6: Consumers are switching spending from dining and apparel to durable goods

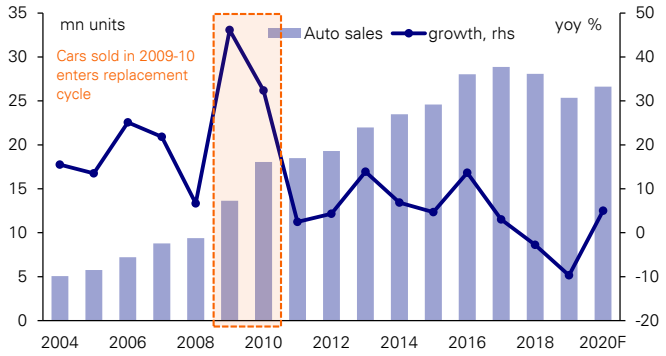


Source : Deutsche Bank Research, NBS, WIND

Additional upside to consumer spending may come from pent-up demand. Household spending fell sharply during the economic lockdown in Q1; household savings-to-income ratio surged to 40% in Q21 from 33% in Q4 2019. As the economy normalizes, households will likely save less and spend more. Savings should return to normal levels as the economy recovers, but it remains to be seen whether households will start to draw down from their additional savings made in Q1. If and when that happens, it will be an additional boost to consumption spending.

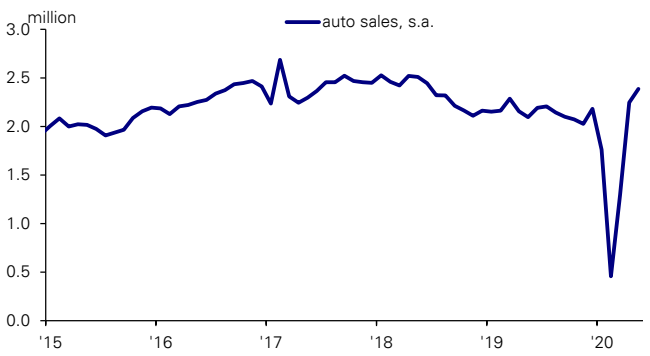
Auto sales will likely stay strong in H2. Auto sales have been very strong in recent months, in fact 5-10% above the level before Covid-19. The auto industry will continue to benefit from an increase in replacement needs. A lot of cars that were sold during the 2009-10 auto boom are now ready to get replaced by new cars. In addition, Covid-19 has made private cars a more preferrable option over public transportation, and a number of big cities have increased their new car plate quotas. Anticipating strong demand ahead, car production is up 20% y/y lately.

Figure 7: Car replacement cycle is expected to boost auto sales in 2020



Source : Deutsche Bank Research, China Auto Industry Association, WIND

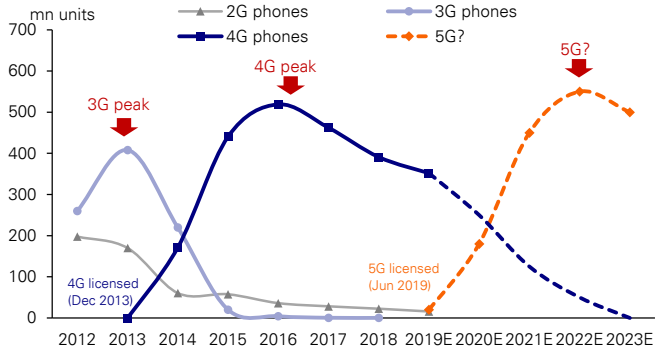
Figure 8: Auto sales have rebounded strongly after Covid-19



Source : Deutsche Bank Research, China Auto Industry Association, WIND

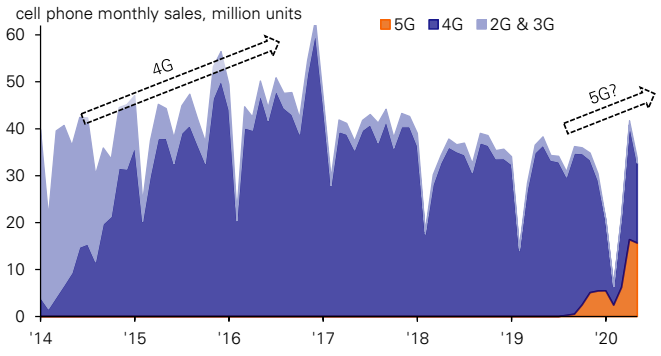
5G smartphone replacement cycle has just started. 5G smartphone sales have picked up in recent months and now accounts for almost half of all smartphone sales. This is despite that 5G network is still being rolled out and the coverage remains limited, the government's plan is to have 5G network available in about 300 cities by end-2020, and to improve coverage in the next few years. 5G phone sales will likely accelerate once 5G network becomes more widely available. If 5G roll out follows the past experience of 4G, it should take over 80% of all smartphone sales by end-2020, and drive up total smartphone sales for the next 2-3 years.

Figure 9: 5G replacement cycle is expected drive up smartphone sales in 2020 and beyond



Source : Deutsche Bank Research, Ministry of Industry and Information Technology, WIND

Figure 10: 5G smartphone sales have picked up after Covid-19



Source : Deutsche Bank Research, Ministry of Industry and Information Technology, WIND

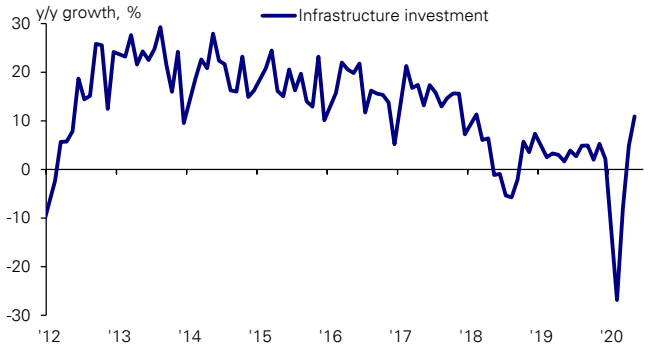
PPI will likely rise faster than CPI

Both CPI and PPI inflation have rebounded in June. PPI inflation improved sharply to 3.0% in June from 3.7% in May, led by higher fuel and steel prices. CPI inflation rose modestly by 0.1ppt, thanks to stabilization of food prices.

In H2, PPI will be supported by government fiscal stimulus as well as recovering global demand. We estimate this year's fiscal stimulus will reach 6% of GDP in 2020, half of which will be spent on public investment (See our report here). Infrastructure investment has already risen sharply; it will likely stay strong in H2 as much of the fiscal stimulus package has yet to be delivered. Moreover, PPI could also benefit from recovering global demand in H2 when major economies exit from

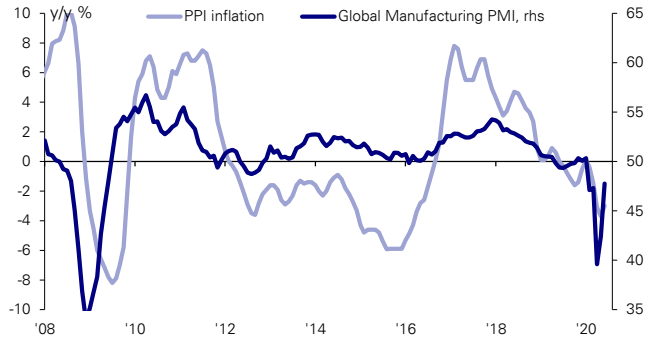
lockdown. Global manufaturing PMI has already rebounded. Our baseline is PPI inflation could rebound from -3% currently to above zero in H2, ending the PPI deflation since mid-2019. Downside risks remain, though, if global demand does not recover and commodity prices fall again.

Figure 11: Infrastructure investment growth reached 9% y/y in May



Source : Deutsche Bank Research, NBS, WIND

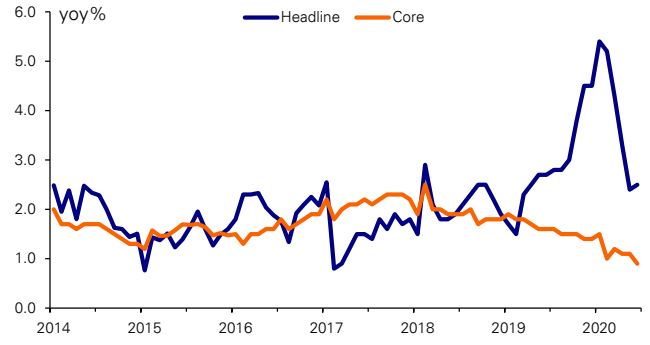
Figure 12: Global PMI rebound will likely support China's PPI



Source :Deutsche Bank Research, Haver Analytics

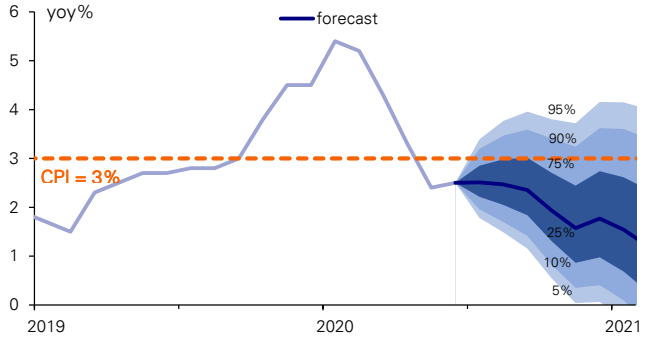
In contrast, CPI inflation will likely stay at low levels. Core CPI inflation is unlikely to pick up in H2. Rent, travel costs, and clothing prices will likely stay low in H2 owing to weak job markets and reduced mobility. Headline inflation is more uncertain, which will depend on food prices, especially pork. Pork prices, after doubling in 2019 owing to the African swine fever, have fallen by about 10% this year thanks to supply recovery, increased imports, as well as reduced demand. Unless pork prices rise further, its high base in H2 last year implies further decline of y/y food CPI in H2. We forecast CPI inflation will fall below 2% by end-2020.

Figure 13: Core CPI inflation has declined since Covid-19



Source : Deutsche Bank Research, NBS, WIND

Figure 14: We forecast CPI inflation will drop below 2% in H2



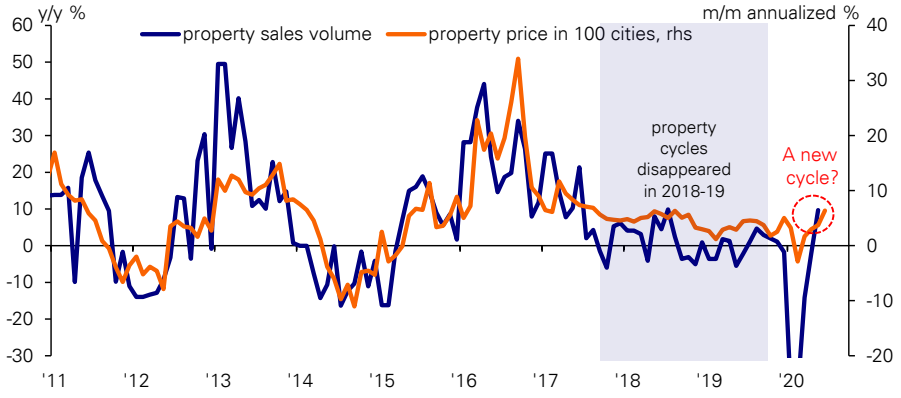
Source : Deutsche Bank Research, NBS, WIND

Will the property market overheat again?

China's property market used to be extremely cyclical, but those cycles have largely disappeared since 2017. Instead, prices and sales have largely moved sideways. The main reason for this is a fundamental change in the government's approach. The central government no longer treats property policy as a countercyclical tool; its overarching goal has become maintaining housing market stability. It has kept mortgage lending rates high and has delegated most other property policy decisions to city level governments. Local governments are allowed to intervene heavily as long as they are able to maintain price stability. As a result, property cycles have become less synchronized across cities, and national level property cycles have disappeared.

More recently, however, the property sector is showing signs of a new cycle. Property sales recovered rapidly from the Covid-19 shock and continued to improve afterwards. In May, propery sales rose 14% y/y in, its highest growth since mid-2018. Propery prices also edged up: prices in 70 cities rose 0.5% m/m in May. Similar to previous cycles, the property market boom is again led by Tier 1 cities: second-hand property prices increased 1.8% in Beijing and 1.6% in Shenzhen last month.

Figure 15: Property market is likely on the edge of another boom



Source : Deutsche Bank Research, NBS, WIND

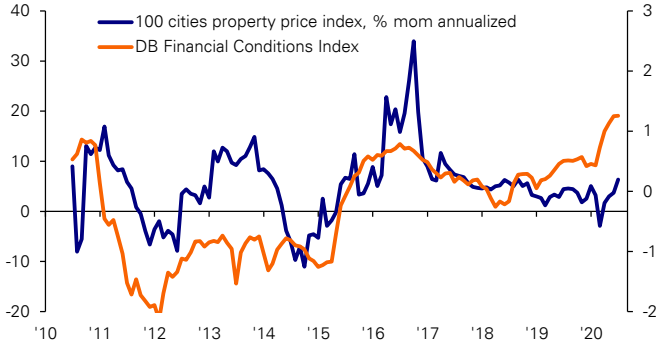
Upward pressures on property prices will likely keep building up in H2. Historically, the combination of large fiscal stimuli and monetary easing have often resulted in property market booms, such as in 2009, 2013, and 2015-16. After the surge of credit supply in H1, it will be difficult to prevent money from flowing into the property market. Moreover, monetary easing have already passed on to mortgage rates; effective mortgage rates have come down about 20-25 bps in H1, which is positive for property prices. Furthermore, housing inventory has decreased in the past few years. Although residential housing supply will also likely increase in the next 1-2 years, new housing units will unlikely flood the market because much of them are already sold in advance: 88% of residential housing sales in 2019 were sold before completion.

Property prices in tier 1 and top tier 2 cities will likely rise more than that in lower tier cities. This is because (i) higher income groups suffered less from the Covid-19 shock; they have more secure jobs, and are better positioned to recover from the shock. In particular, financial and IT sectors, whose employees are more concentrated in top tier cities, recorded positive growth in Q1; and (ii) housing prices did not increase much in the top tier cities in the past few years. Prices have

become relatively more attractive in top tier cities compared to lower tier cities (Figure 12).

Property market boom would be good news for the economy but a challenge for policymakers. The government will try hard to prevent property price bubbles with all its available policy tools. If property prices continue to rise, mortgage borrowing will likely be tightened again. The end result is likely a moderate increase in property prices---about 5% each year in 2020-21---and widespread purchase restrictions and price controls across higher tier cities.

Figure 16: Monetary easing could lead to property market booms



Source : Deutsche Bank Research, NBS, WIND

Figure 17: Residential housing inventory decreased in the past 5 years

Source : Deutsche Bank Research, NBS, WIND

Policy turns more balanced

Fiscal and monetary policy stances will likely shift from one-sided easing to a more balanced approach. Policymakers will need to balance between upside and downside risks. A premature exit of stimulus might interrupt the recovery, while a belated policy exit might fuel asset price bubbles.

Fiscal policy will likely follow through on committed stimulus measures. We think the government will deliver its 6% of GDP stimulus in full by end-2020 to support employment and protect the poor. Employment is the government's most important policy goal this year, absent a GDP growth target. Unemployment pressures will remain high from slack in labor-intensive sectors such as export-oriented manufacturing, dining, and leisure. Fiscal spending is the most effective policy tool to create jobs. Sheltering the lower income families is equally important to achieve the government's long term poverty reduction goal that is due this year. It is unlikely, though, for the government to introduce additional fiscal measures.

Monetary policy has room for fine-tuning to curtail risks of overheating and asset bubbles. Monetary policy has already shifted from broad-based easing to targeted policy instruments for SMEs. Performance of the real economy is unlikely to change the course of monetary policy. We expect policy rates will stay unchanged at current low levels as long as headline GDP growth stays below 6% and CPI inflation remains subdued. The biggest concern for the PBOC in H2 is likely financial stability. If asset prices, especially property prices, start to rise at accelerating speed, PBOC will have to tighten through macroprudential measures (e.g. on mortgage lending and shadow banking) as well as liquidity withdrawals from the financial system.

RMB: Remaining constructive

Bottom line: *USD/CNH remains stuck at around 7, despite improvements in local data and a weaker USD environment. We would put the resistance to the downside in the pair as mainly to market concerns over US-China friction, which increased further this week with US asking for China to close its consulate in Houston. These geopolitical headwinds aside, fundamentals continue to argue for RMB appreciation. One, we continue to expect basic balance dynamics to remain strong in remainder of the year, including because of both offshore portfolio inflows, and with the current account outlook improving, in part because of compression in the services deficit and low oil prices. Two, with the recent correction in FX valuations pushing RMB closer to 'fair value' and the RMB well away from the recent highs of the CFETS basket, the authorities continue to look comfortable with allowing it to appreciate. The negative tail risk to the outook comes from the upcoming US election. Although we admit that the trade deal between US and China could potentially fall victim to the election dynamics, particularly with China's purchasing of US goods falling well behind its target, we see little incentives for either side to pull out of the deal. We remain cautiously optimistic on RMB and retain our downside exposure to USD/CNH via options.*

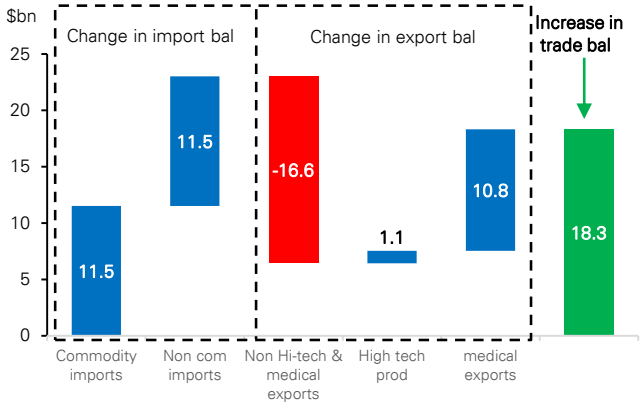
Remaining constructive

USD/CNH remains stuck at around the 7 level, despite improvements in data and a weaker USD environment. The lack of price action is mainly due to ongoing market concerns over US-China friction, including the recent US order for China to close its consulate in Houston. Despite the political headwinds, fundamentals remain ripe for RMB appreciation.

Widening current account surplus to stay

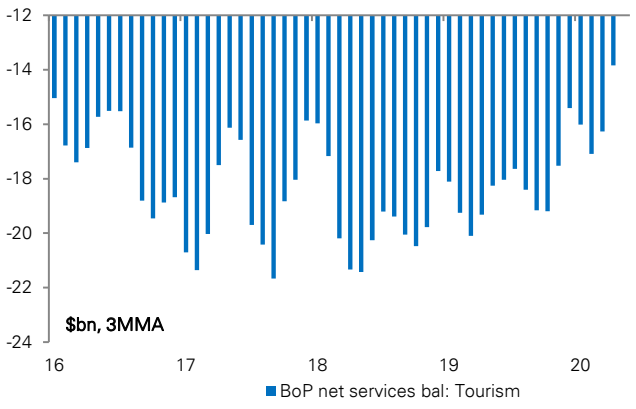
In previous downturn episodes, like the 2008 GFC period, China external adjustment was notable. In 2008, China's current account surplus narrowed from 9.2% to 4.8% of GDP by 2009, and it continued to narrow over the subsequent years. This time around, China's current account surplus is actually widening due to: (1) notable import compression in both commodity imports and non-commodity imports, (2) rising demand for medical and electronic devices, and (3) sizable savings on tourism expenses. We believe that the improvement in the current account will sustain with an average of $20bn per month in 2H.

Figure 18: Recent improvement in trade is due to a fall in commodity prices, and rising demand for medical and electronic devices



Source : Deutsche Bank, CEIC

Figure 19: Over the past few months, the tourism deficit has been actively narrowing



Source : Deutsche Bank, CEIC

Following the successfully containment of the virus in China, China's trade recovery exceed our expectation with its trade balance widened to $54bn per month in April/May (from last year's average of $36bn). On the import side, it was the commodity import compression that aided the widening of the surplus. In April/May, commodity imports compressed by $12bn per month driven by the notably fall in commodity prices particularly oil prices (~40% YTD). Crude oil and refinery products make up 67% of China's commodity imports, while the remainder is mainly comprised of base metals, like iron and copper. With our commodity colleagues expect Brent to hover around $45 in 2H, China's crude oil and refinery product imports would shrink by $7.3bn per month, with each $10 lower in Brent contributing a $3.8bn compression per month of the former. Base metal imports will be at most flat, as China resists the aggressive use of the property and 'old infrastructure' investments—i.e., building roads and highways to boost growth. This is evident in the government's tightening of property market policy in four big cities (including Shenzhen), heightened inventory levels of iron ore, and the central government's strong advocation for "New Infrastructure," which is less commodity intensive.

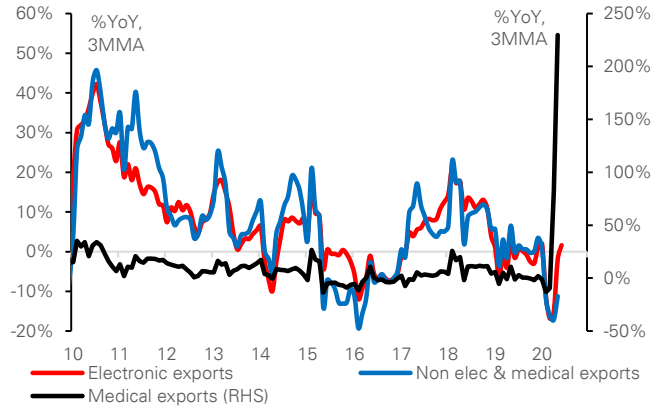
On the export side, high-tech goods (which consist of computers and internet devices, and which make up ~30% of total exports) have added $1.1bn per month to the trade balance, while medical exports (used to be ~5% of total exports) contributed another $10.8bn per month in April/May. However, before a COVID-19 vaccine or a cure becomes available to the general public at an affordable price, demand for medical products (like masks, sanitizers, and protective suits) will likely remain albeit at a lower level especially if the number of cases falls. We estimate that medical exports will continue to add $3.9bn per month to China's trade balance in 2H if medical products demand halved from April/May level. In the 'living-with-a-virus' world, the surge in distance-working/-learning should bode well for the semiconductor sector, and thus for China's high-tech exports. Seasonality also points to higher 2H high-tech exports compared to 1H. We believe that the strength of high-tech exports will continue and at least recover to 2H19 level, and that this will widen the trade balance by $5bn per month in 2H .

Figure 20: Key policy documents and official statements underpinning the "New Infrastructure" initiative

Date	Meeting	Comments
Jan-20	State Council meeting	Vigorously develop advanced manufacturing, introduce information network and other new infrastructure investment support policies
Feb-20	Politburo meeting	Develop conventional and new infrastructure, build a system of modern infrastructure network which is smart, green and safe
Mar-20	Standing Committee of the Political Bureau of the CPC Central Committee	Accelerate the construction of new infrastructure such as 5G networks and data centers
Apr-20	State Council meeting	Accelerate the construction of new infrastructure such as 5G networks and data centers, and step up the layout of the digital economy
May-20	National People's Congress	Strengthen next generation new infrastructure construction

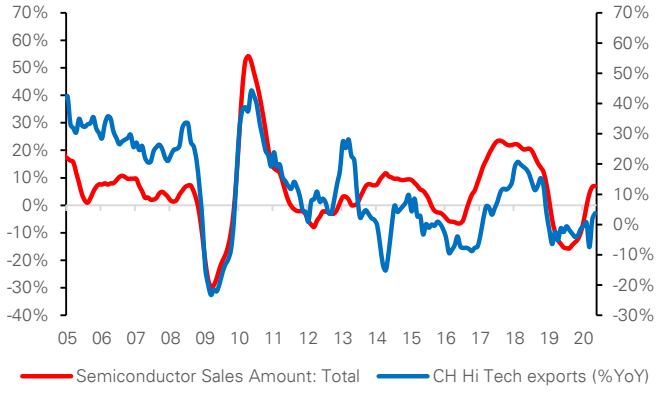
Source : Deutsche Bank, Bloomberg Finance LP, Xinhua

Figure 21: Rising demand for medical and electronic devices has been the big driver behind the Chinese export recovery



Source : Deutsche Bank, CEIC

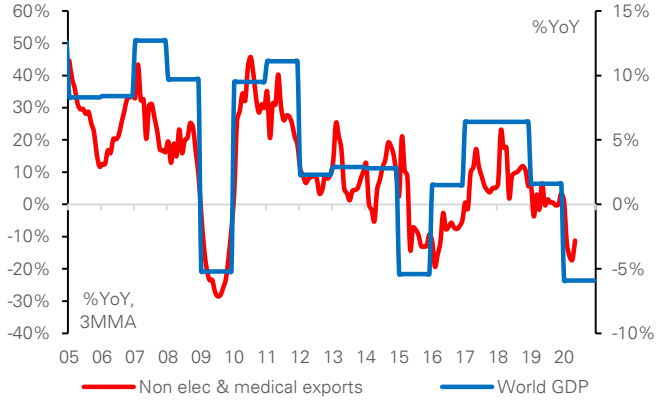
Figure 22: Rising global semi-conductor sales suggest further upside potential for China's high-tech exports



Source : Deutsche Bank, CEIC

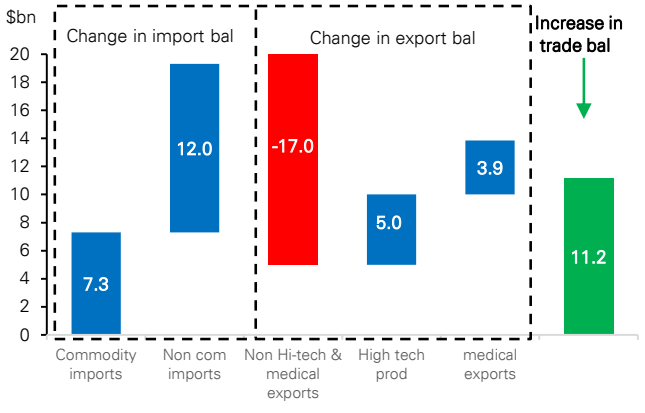
There is still loss in non-high-tech and non-medical exports ($-16.6bn), but it is largely offset by reduction for non-commodity imports ($11.5bn) in April/May. This is not surprising, given that China is 'the world's factory,' with a significant portion of its trade being involved in the import-process-export cycle. Indeed, the growth rate of non-commodity imports closely tracks that of non-high-tech and non-medical exports. To be sure, the non-commodity imports outlook could be even dimmer, given the weak global growth outlook and the central government's focus on encouraging domestic purchasing of goods "Made in China." We believe it is reasonable to assume that the compression in the two will continue to offset one another and leave only a narrow deficit. Therefore, we expect the net trade balance of the two to be at the same level of April/May ($-5bn) in 2H. As such, we estimate that on a monthly basis, China's trade balance surplus should increase by at least ~$11.2bn.

Figure 23: The lack of a global growth recovery should continue to suppress non-electronic and medical export growth



Source : Deutsche Bank, CEIC

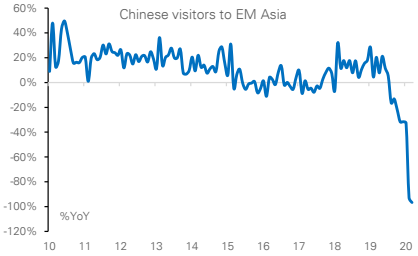
Figure 24: We expect China's monthly trade balance surplus to increase by at least ~$11.2bn



Source : Deutsche Bank, CEIC

Unlike the past, the widening trade surplus would not be recycled by the normally large services deficit this time around. In fact, the services deficit narrowed by $9bn per month in April/May, with diminishing tourism expenses. Chinese visitors to EM Asia were almost absent, given concerns over COVID-19 and border controls. We believe that the same pattern will likely appear other regions as well. The other large portion of tourism expenses (overseas student spending) has also compressed heavily in the post-Covid-19 world. While other services deficits are not likely to expand, we expect the current accounts balance to widen by round $20bn per month in 2H.

Figure 25: Ongoing travel restrictions should continue to suppress overseas spending



*Source : Deutsche Bank, CEIC *EM Asia include Hong Kong SAR, Macao, Korea, Indonesia, Thailand and Singapore*

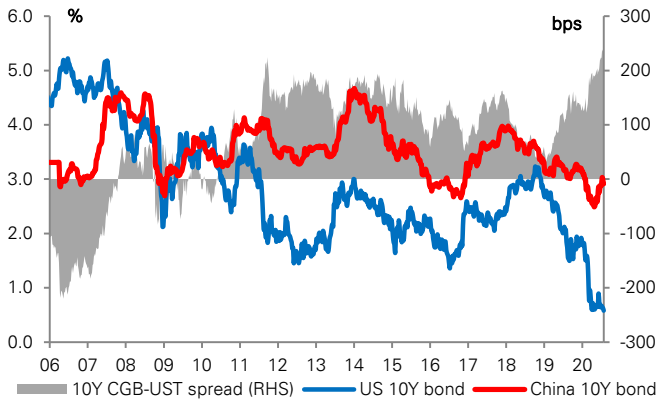
An insatiable appetite for Chinese assets

YTD, demand for Chinese assets has been insatiable. After Korea, China has recorded the second-largest amount of bond inflows in Asia (~$45bn). We believe that this strong appetite is being driven by three factors: (1) the ability to find natural buyers of Chinese bonds, despite sizeable issuances; (2) China's willingness to aggressively ease in order to support growth – apart from reducing MLF rates by 30bps, the PBoC has injected on average ~RMB1trn of liquidity per month into the system in order to support growth (almost twice the amount that it injected in 2019); and (3) China's ability to contain COVID-19 and to limit its economic impact. In addition, as China moves toward its final target weightings in the Bloomberg-Barclays Global Aggregate Index (full inclusion by November 2020) and the JP GBI-EM index (full inclusion by December 2020), it has attracted on average ~$7.5bn of bond inflows per month.

Heading in 2H20, we expect these inflows to persist. Why? **First, monetary policy adjustments have been completed**. In the past month, as a growth recovery has become more evident, the PBoC has unwound sizeable amounts of excess liquidity within the system, resulting in the re-convergence of interbank rates with reverse repo rates. We believe the process is now complete and that the PBoC has no desire to further tighten monetary conditions. This is evident from recent comments made by the deputy head of the Monetary Policy Department (on 10 July), stating that the role of the PBoC is still to meet the State Council's directive of keeping lending costs low. **Second, the search for yields continues**. As yields across the G10 have declined (including in the US), the recent sell-off in Chinese bonds has made them attractive, particularly with the interest rate differential between 10Y UST-CGB at ~230bps (as of writing), the widest on record. With China having completed its monetary policy adjustments and the interest rate differential still wide, bond inflows into China are likely to remain strong. **Third, potential inclusion of Chinese bonds into the FTSE Russell WGBI in September**. In March, FTSE kept China on the Watch List due to technical issues (such as QFII and RQFII quotas and a lack of flexibility in FX execution). Over the past few months, China has made a number of changes in order to address these issues; the latest was in May, when the QFII and RQFII quotas were removed and qualified investors were allowed to face multiple domestic custodians. With China actively addressing these issues, we believe that the WGBI is likely to upgrade it to Market Accessibility Level 2 this September. If so, bond inflows into China could pick up further. Given that there is ~$3trn in funds tracking the WGBI and that China's inclusion would lead to a 5-6% weight allocation, we believe that China could see ~$150-160bn in bond inflows. Like the other index providers, we assume FTSE will stagger the inclusion over a period of 20 months. This means that China should see ~$7.5-9bn of bond inflows per month. Although inclusion might only start early next year, we believe that active funds will pre-position themselves ahead of inclusion. This should not be a surprise. Looking back, when Bloomberg and JP announced the inclusion of Chinese bonds in their indices, bond inflows picked up well before the inclusion date – and things should

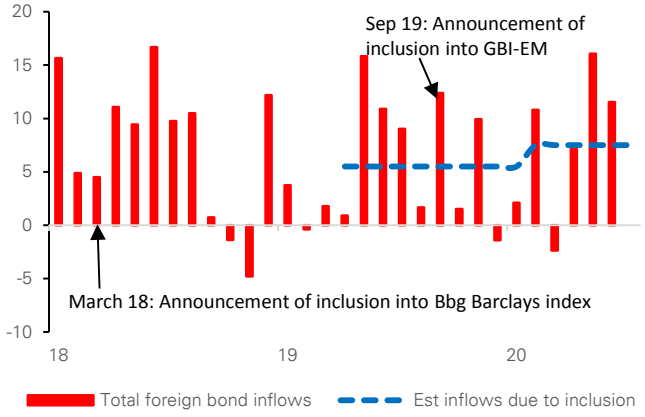
not be any different this time. This, coupled with the already strong bond inflows due to the current inclusion, should continue to exert pressure on the RMB to appreciate.

Figure 26: UST-CGB 10Y spread is the widest on record



Source : Deutsche Bank, Bloomberg Finance LP

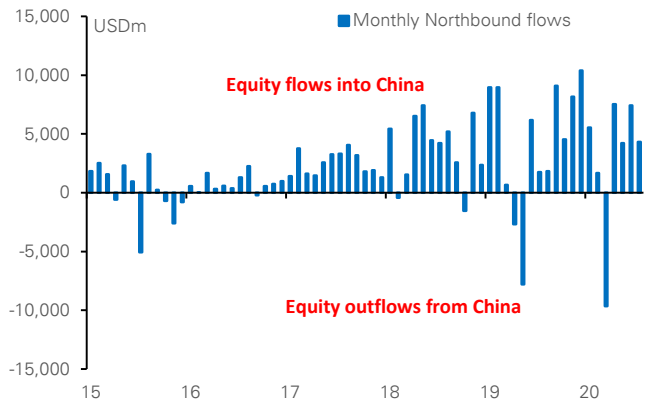
Figure 27: Historically, funds have pre-positioned themselves ahead of the inclusion start date



Source : Deutsche Bank, CEIC

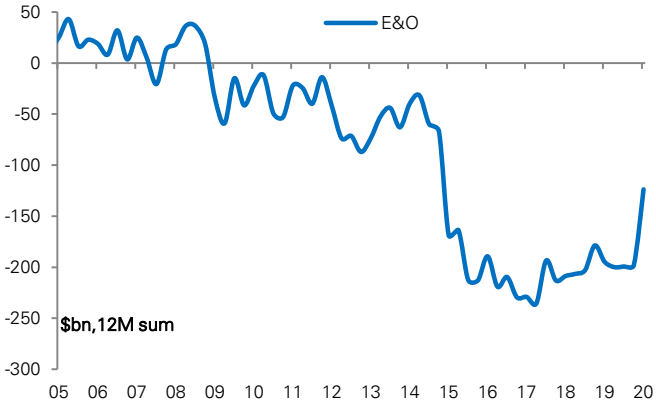
Equity inflows into China should also continue to improve. YTD, foreign investors have purchased ~$21bn of Chinese equity via the Northbound connect. Although inflows stand at only 42% of the full-year 2019 level, we believe that these flows should pick up more decisively in 2H20, for a few reasons. First, the ongoing improvement in growth has helped support upward earnings revisions. In recent months, this has encouraged a pick-up in equity inflows via the Northbound stock connect. Second, the equity valuation of the Shanghai composite still looks cheap, particularly vs. its Asian peers. Third, the ongoing US-China tension has seen a rise in Chinese companies looking to be listed now in China rather than abroad. Given that, this would attract more inflows into China for investors look to invest in these newly listed firms.

Figure 28: Equity inflows into China have been improving



Source : Deutsche Bank, CEIC

Figure 29: 'Hot money' outflows have slowed notably, although it is too early to tell if this will persist



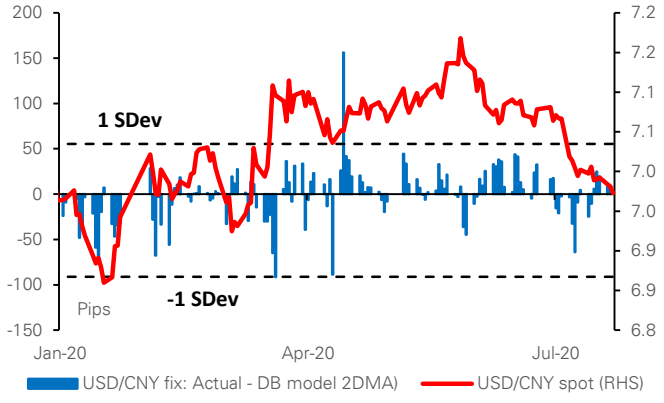
Source : Deutsche Bank, CEIC

The strong inflows are not confined only to portfolios: corporate inflows have picked up as well. The latest exporter FX conversion ratio shows that the recent RMB appreciation and improvements in data have resulted in a gradual pick-up in repatriation. In addition, 'hot money' outflows have decreased notably. In the 1Q BoP data, error and omission (E&O, which we define as 'hot money') turned positive for the first time since March 2014. Although it is still too early to tell if these trends will persist, for the time being, the ongoing repatriation supports a stronger RMB.

Policymakers remain comfortable with RMB appreciation

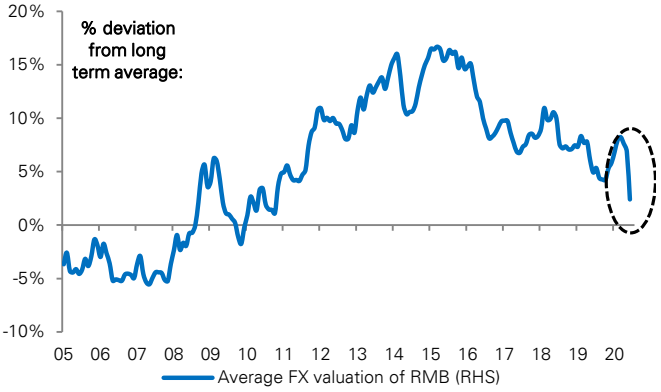
Despite the recent currency movement, the PBoC has maintained its relatively hands-off approach toward the market. Its 9.15am USD/CNY fixes in recent days have not shown any strong bias toward slowing RMB appreciation. Indeed, there is little reason for China to be concerned about RMB appreciation. **Although the RMB has appreciated by 0.9% against the CFETS trade-weighted basket over the course of the past month, the basket is still ~4% below this year's high (95.5), in part due to the strong performance of G10 currencies (such as the EUR).** In addition, over the past few months, **the RMB has undergone a notable valuation correction**. Taking the average of our three FX valuation models (PPP, BEER, and FEER), the RMB is now just ~2.4% overvalued. This is well below the recent high of being ~9% overvalued in February and 16% overvalued in 2015. More importantly, allowing the RMB to appreciate should help China attract more foreign inflows, particularly in the bond market, given the sizeable amount of CGBs that are still to be issued this year.

Figure 30: PBoC shows weak bias against the recent RMB apprecation...



Source : Deutsche Bank, Bloomberg Finance LP

Figure 31: ...particularly since RMB is becoming more fairly valued



Source : Deutsche Bank, Bloomberg Finance LP, Haver Analytics

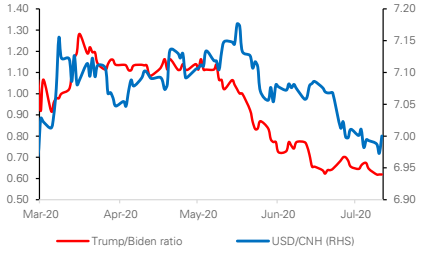
US election – good or bad for RMB?

One risk to our constructive view on RMB is the upcoming US presidential election. As highlighted by our FX colleagues (See Biden's Big Break? – EM and the US Presidential Election, 22 July 2020), the past four years of the Trump administration have had a negative impact on EM FX. High levels of policy unpredictability and a willingness to use tariffs as a policy tool have resulted in EM FX underperformance compared to its G10 peers – and the RMB is no exception. Since the breakdown of the US/China trade relationship in 2018, the RMB has been on weaker footing. Heading into the US election period, we admit that any significant rhetoric from either of the presidential candidates regarding the state of US-China relations (including any change to tariffs applied to Chinese goods) could inject headline risk

into RMB. However, recent comments from the administration suggest they remain keen on decoupling the trade issue from its other engagements with China (e.g., issues like Hong Kong and technology export controls). In addition, we believe that the recent pick-up in agricultural purchasing by Chinese authorities suggests a desire by them to keep the current trade deal intact.

More importantly, the ongoing widening in the lead that former Vice President Biden has over President Trump has also helped reduce some of the risk premium the market has priced into USD/CNH. Why? (1) If VP Biden were to win, the prospects for further tariff escalations under a Biden administration would likely be lower than they have been under the Trump administration, given Biden's promise of taking a more multilateral approach to trade as highlighted in the EM piece above. (2) A Biden victory would be more likely to lead to a 'more formal' policy framework, likely reducing market uncertainty regarding policy announcements. As such, we believe that if the lead widens further, a further reduction in the risk premium in USD/CNH is likely. Given the proximity to the election, China will also likely continue to lean against RMB weakness to avoid worsening US-China tension.

Figure 32: Former Vice President Biden's widening lead over President Trump have reduced some of the risk premium in USD/CNH



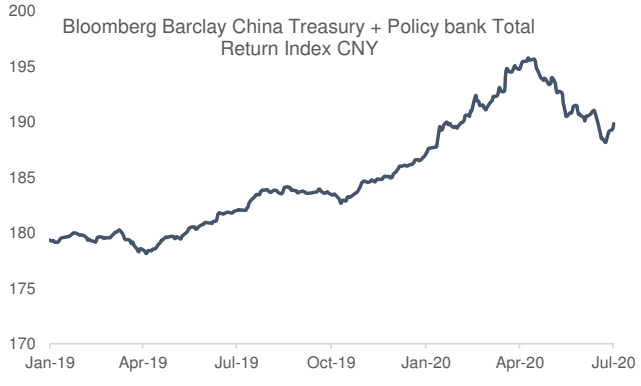
Source : Deutsche Bank, Bloomberg Finance LP

Fixed income outlook: Rates normalization

Introduction

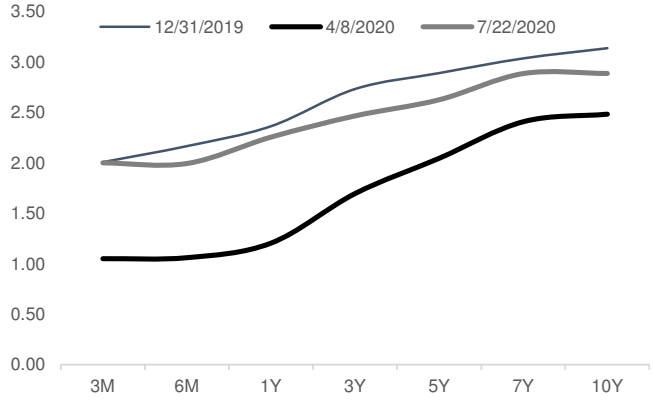
RMB CGBs and policy bank bonds delivered a YTD total return of 2.1% in RMB as of July 22nd, according to the Bloomberg Barclays Global Aggregate Index. In Q1, RMB bonds performed strongly (3.59% total return on CGBs and policy bank bonds in Q1) as monetary conditions were relaxed significantly upon the initial shock from the COVID19 pandemic and real GDP growth contracted by 6.8% YOY. RMB yield curves bull-steepened and the bullish tone carried to early April when the 10Y CGB yield set a historical low of 2.48% on April 8th . As growth began to recover, monetary conditions tightened on the margin, heavy supply pressure associated with fiscal expansion and an equity rally led to significant bear flattening of the CGB yield curve and the 10Y CGB yield bounded back to 3.08%, 5bps below where it was by the end of 2019. Since the start of Q2, the CGB/policy bank bond market has suffered a loss of 1.40% so far. With bond yields now reverting to where they were pre-COVID19, what are the key risks and investment themes in the RMB bond market and how should we position in the market before the year end? We present our thoughts in detail in this report.

Figure 33: 2% YTD total return on CGB and policy bank bonds



Source : Deutsche Bank, Bloomberg Finance LP

Figure 34: CGB yield curve bounded off its lows(%)



Source : Deutsche Bank, Wind

H2 outlook: Rates normalization

We believe RMB interest rates normalization (upward trend both in the level and volatility of RMB rates) – will be the key theme in H2 based on assessment of the following:

(a) **Growth recovery:** economic growth will continue to recover at a faster pace on YoY terms in H2 than in H1 as the domestic pandemic situation is under control; we revised up GDP growth forecasts to 4% in Q3 and 5% in Q4 followed a stronger than expected Q2 real GDP growth at 3.2%YoY;

(b) **Policy shift:** with positive growth momentum and emerging signs of speculative investment in the equity and property market, macro policy has turned towards managing the risk of asset reflation and macro leverages and monetary accommodation has shifted towards relying on structural/targeted tools which will slow down money supply growth and normalise domestic liquidity;

(c) **Asset rotation:** with improving outlook on growth and corporate earning, risk appetite is increasingly gravitating towards equity and credit asset allocation, out of safer fixed income assets;

(d) **Supply moderation:** The pace of bond supply will moderate in H2, while supply remains heavy from government debt financing, we think most of the supply risk has been priced in.

(e) **Global risks:** Globally, strong monetary and fiscal responses to the COVID19 crisis in major economies, positive development on COVID19 vaccine should support sequential growth recovery in major economies in H2 2020 which implies global core rates will trend up, although central bank buying/QE of government bonds acts as a constant pull factor against such an uptrend. US election and escalation of US-China tension are key global event risks which adds to the volatility risk both on RMB rates and FX.

Domestic liquidity: the tide is turning

Domestic liquidity condition is primarily determined by macro policy stance. In H1, monetary policy focused on liquidity accommodation and credit support and the PBoC deployed broad-based easing by both quantitative tools and interest rate cuts. Specifically, RRR was cut three times which released RMB1.8trn liquidity, about RMB1.8trn new relending/rediscounting quota was announced to support credit growth to private business and the SME sector. OMO/MLF rates were cut by 30bps YTD and the relending/rediscount rates were cut by 25bps.

Transmission of such monetary easing to domestic liquidity and credit growth has been reasonably effective. M2 growth rose to 11.1% in June from 8.7% in Dec 2019, the highest level in the past three years; new RMB loans in H1 surged to RMB12trn, about RMB2.4trn more than it was in H1 2019 and aggregate social financing growth reached RMB20.83trn (driven by bank loan and government and corporate bond financing growth), about RMB6.2trn more than it was in H1 2019. Money market liquidity was considerably flush, with the average of benchmark repo rate at 1.88% and average overnight repo and 7D repo rates at 1.48% and 1.98% respectively, about 60-80bps lower than they were in H2 2019. The overnight repo rate hit a historical low over the past two decades in April 2020 at 0.68%, and the 7D repo rate fell to its lowest level over the past decade at 1.3%.

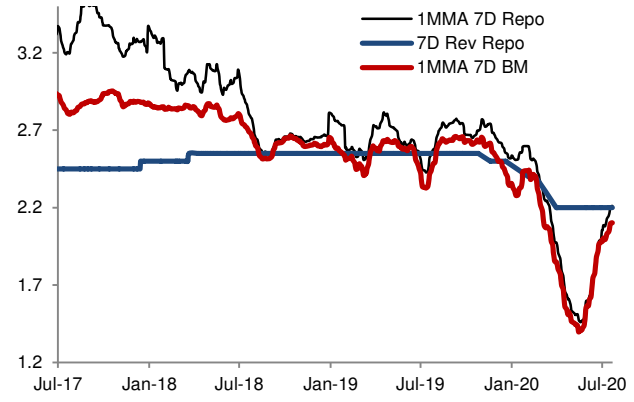
With the COVID19 pandemic under control domestically and fiscal spending having stepped up since late April, the PBoC began to fine-tune its liquidity stance by allowing its various liquidity facilities to mature. PBoC balance sheet stood at RMB36.4trn by the end of June, about RMB720bn lower than it was as of December 2019. Its "Claim on depository institutions", reflecting outstanding balances of various liquidity facilities, fell by RMB612bn, of which the outstanding balance of MLF, TMLF and PSL facilities fell by RMB140bn, RMB226.4bn and RMB28.4bn respectively during H1. As such, money market rates staged a V-shape correction across the repo and Shibor curves and 7D benchmark repo fixing rate bounced back to around 2% currently.

Monetary policy will be less accommodative in H2. As stated in the Q2 monetary policy minutes, the PBoC intends to keep its policy stance prudent with increasing flexibility. However considering: (a) growth recovery in H2; (b) the risk of speculative/capital inflows against the backdrop of flush global liquidity and China is increasingly opening up its capital account and financial service sector; (c) domestic asset reflation risk in the property and equity market, **we expect China's monetary policy will be less accommodative in H2 than in H1.**

Specifically we expect (a) credit growth will moderate. We forecast RMB8trn new RMB loans and RMB9.2trn new aggregate social financing growth in H2; slower credit growth will translate into slower growth in domestic liquidity; (b) structured and targeted tools will replace broad-based tools – the RMB1trn relending and rediscounting quota and the two newly introduced policy tools (RMB40bn loan extension facility and RMB400bn credit support facility) to support lending to the SME sector; (c) Room for loan rates will fall even as policy rates are held steady as banks reduce profit margin. The State Council decided in June commercial banks will give out RMB1.5trn profit margin to the borrowers in 2020. Recently the PBoC gave the detailed breakdown of the calculus behind this RMB1.5trn – (a) RMB930bn from lowering lending rates (including corporate loan rates, bond yields, relending/rediscount rates), (b) RMB230bn from direct credit facilities and short term interest rate relief to corporate and small business; (c) RMB320bn from lowering fee charges for banking services. We think the policy guidance of lowering corporate financing cost leaves room for a 5-15bps cut in 1Y LPR rate in H2 even if 1Y MLF rate will be stable, ie. the spread between the 1Y MLF and 1Y LPR rate may narrow to 75-85bps from currently at 90bps. 5Y LPR rate is more likely to stay unchanged in H2. We expect LPR rate cuts to benefit primarily loan borrowers and have limited impact on RMB bond yields.

We expect money market rates will re-align with short term OMO rates – 7D reverse repo rate and are likely to be more volatile in H2. As the liquidity tide is turning, interbank funding cost will normalise around the borrowing cost the from the central bank, ie. OMO rates, currently the 7D reverse repo rate at 2.2%, 30bps lower than it was in 2019. Evident during 2018-2019, China established a tentative interest rate targeting framework in which the benchmark 7D repo rate broadly centred around the 7D reverse repo rate and we expect such a framework to resume as liquidity condition normalises. However we see the risk of higher volatilities in money market rates due to (a) structural and targeted easing increases the uncertainties in the central bank's liquidity accommodation; short-dated reverse repo operations will be the main tool to provide money market liquidity, and medium term liquidity tools such as MLF are more expensive (1Y at 2.95%) therefore less favorable; (b) equity market recovery and IPOs tend to drive up equity financing demand which pushes up interbank funding cost indirectly; (c) regulatory scrutiny over leverage financing risk in the financial markets is likely to be combined with liquidity tightening to manage leverage risk; (d) cross border investment inflows will be more volatile given flush global liquidity, global event risks and freer access to capital market. Offshore investors held a total of RMB6.4trn domestic assets (equities, loans, bonds and deposits) by the end of March 2020 (June data is yet to be released), and offshore inflows to the bond market was RMB305bn (USD43bn) in H1. **We forecast 7D benchmark repo rate to average at 2.10% and 7D repo fixing rate to average at 2.3% in H2.**

Figure 35: Money market rates realigning to 7D reverse repo rate

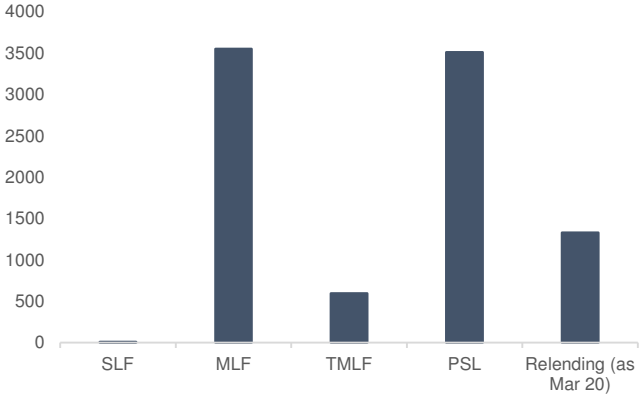


Source : Deutsche Bank, Wind

Figure 36: Money market condition has been tightening

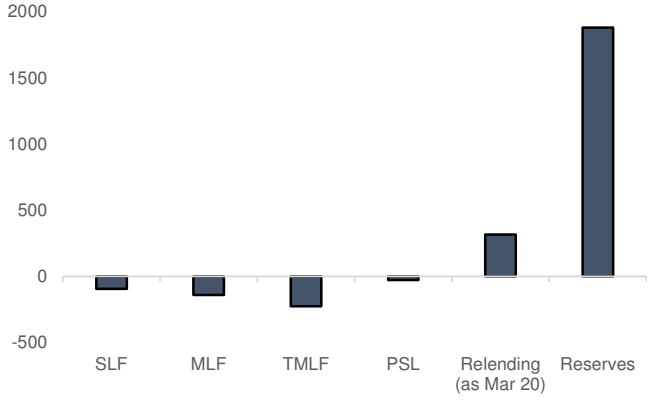
Source : Deutsche Bank, Wind

Figure 37: Outstanding balances of PBoC's quantitative facilities (RMB bn)



Source : Deutsche Bank, PBoC

Figure 38: Liquidity impact from changes of PBoC's tools (RMBbn)



Source : Deutsche Bank, PBoC, here Reserves reflects liquidity impact from RRR cuts to the interbank market, Relending/Rediscounting balance was as of end of March 2020

Term premium normalization

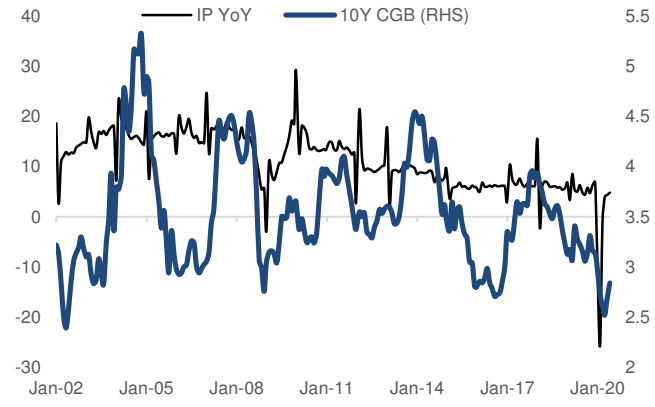
10Y CGB yield should range 2.9-3.1% as term premium normalizes. From a cyclical perspective, one key aspect of the RMB rates normalization theme that we envisage in H2 is the term premium normalization. Prior to COVID19, China's long term risk free rate was in a cyclical downtrend since January 2018 as China began to address its structural imbalances by reducing leverage risk and US-China trade dispute began to intensify. China's long term growth outlook improved following the Phase One trade deal in January 2020. During the same time, 10Y CGB yield declined from 3.96% to just above 3% before COVID19. However China's long term growth expectation weakened after the COVID19 growth shock and the RMB long term rate continued its cyclical downtrend – 10Y CGB yield fell to a historical low of 2.48% in April. As growth began to bottom out in Q2, 10Y CGB yield had a similar V-shape recovery and now trades at 2.90%. The term premium implied by the yield differential between 10Y CGB yield and the monthly average of 7D repo rate since 2016 averaged at 16.6% of the 10Y CGB yield and it was at 20% before COVID19. Moreover, taking into account of the strong CGB supply associated with strong fiscal responses post COVID19, we believe a 20-25% term premium will give us a

comfortable normal level of long term rate – which would imply 10Y yield at 2.9-3.1% based on our forecast 7D repo fixing at 2.3%.

Historically the RMB long term rate has demonstrated a strong cyclical trend in that on average, each bull or bear market lasts for at least a year and the absolute level of yield adjustment is approximately 100bps in each cycle. The previous bear market was during October 2016 to November 2017 when 10Y CGB yield rose from 2.65% to 3.98%. Following that the bullish run on RMB bonds during November 2017 - January 2020 with 10Y yield almost 100bps lower to 3%. If history is of any guidance, we think the current uptrend of long term rate could run as high as 3.4%.

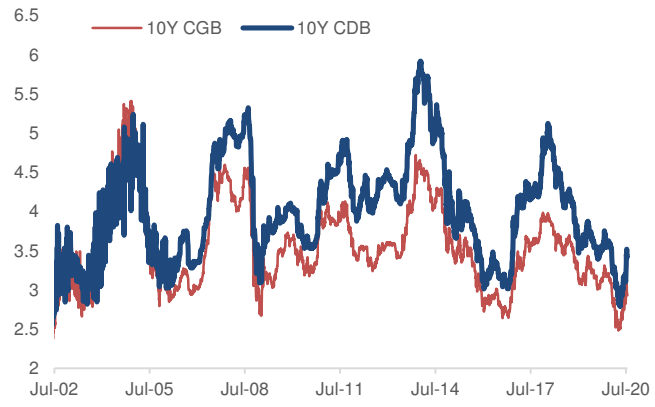
We forecast the 10Y CGB yield to range between 2.8-3.4% in H2 when factoring in volatility risk. Along with a cyclical uptrend in long term rate, long term rates volatility will likely go up driven by both equity-fixed income rotation and money market rates volatility. Uncertainties around the COVID19 pandemic and global growth, US - China tension escalation are key risks, which add both volatility and breakup risks in the trend, and taking all the above factors into account, we expect the 10Y CGB yield to range between 2.8-3.4% in H2.

Figure 39: V-shaped recovery in growth and long term yield (%)



Source : Deutsche Bank, Wind

Figure 40: 10Y yields back to where they were pre-COVID19



Source : Deutsche Bank, PBoC, Chinabond, Wind

Supply and demand technicals

We expect supply pressure of CGBs remains heavy in H2 with net supply of CGB to rise by 66% from H1 and RMB400bn net issuance per month on average in H2. We forecast net financing by local government and by policy banks will drop by 30% and 15% respectively from H1. We estimate up to RM1trn net corporate credit supply in H2. For details, please refer to our H2 RMB bond supply outlook.

We expect demand for CGBs, LGBs and policy bank bonds will be supported by commercial banks, asset management funds and offshore investors. As commercial banks take credit risks via their loan portfolio, their bond allocation will prioritize central and local government bonds. Asset rotation led to redemption flows out of bond funds into equity funds during May-July, and such a risk will likely constrain the pace of fixed income allocation by asset management funds in H2.

We expect offshore inflows to accelerate in H2 and we maintain our forecast of RMB1190bn (USD170bn) net inflow for full year 2020 because of (a) valuation of

CGB and policy bank bonds is increasingly attractive to global reserve managers and offshore institutions on widening China-US interest rate differential (10Y yield differential at 230bps); (b) the prospect of RMB bonds to be included into another major global bond index as China continues to relax market access and integrate interbank bond market with exchange market; (c) diversification allocation demand into RMB assets given the weakening trend of the USD.

Credit outlook

In H1, corporate credit yields fell along with the CGB/policy bank bonds thanks to favorable credit support policies post COVID19, however credit spreads of corporate credit widened by 40-60bps in 5Y tenor for AAA rated and A rated enterprise bonds and MTNs, indicating the market was repricing weaker credit fundamentals.

However, credit default risk has not deteriorated materially relative to 2019. There were 66 series of corporate credit defaults with a total notional amount of RMB93bn, about 64% of the 2019 full year defaulted bonds. Privately owned enterprises however, accounted for 50% of the H1 defaulted bonds, followed by central and local state owned enterprises which collectively accounted for 40% of the H1 defaulted bonds.

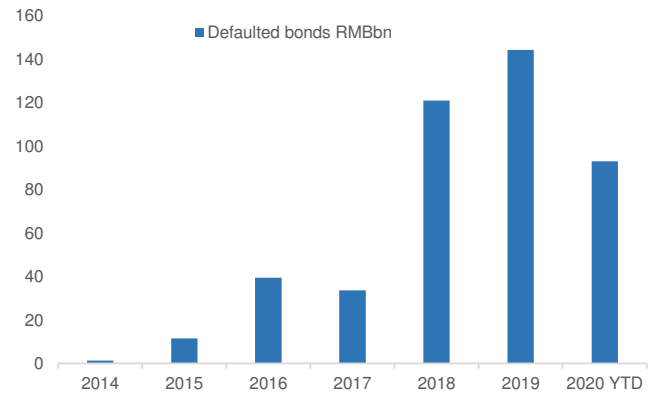
The number of newly added issuer defaults was much less in 2020 than in 2019 – eleven new issuers defaulted on RMB13bn bonds in H1 vs. 40 new issuers defaulted on RMB36bn bonds in 2019, suggesting domestic credit default risk in H1 2020 had not materially deteriorated.

We expect credit risk to remain stable in H2 – (a) PBoC's relending/rediscounting tools and newly introduced tools to support SME financing will help contain corporate defaults; (b) the plan to use funding proceeds from local government bond issuance to recapitalize weaker banks (likely RMB200bn at least) will help address the liquidity and solvency risk of SME banks which have suffered rising NPL risk post COVID19; (c) on July 17th the takeover of nine insurance business by financial regulators suggests weak financial institutions with legacy problems continue to be wound down. We expect credit differentiation will favor highly rated credit names.

Investment Strategy: Our RMB rates normalization theme in H2 argues for keeping modest duration exposure in the near term and earning carry by owning duration at the front end of CGB and CDB bonds (5Y or lower tenors) outright or hedged with CNH CCS. We will consider extending duration when 10Y CGB is at 3.2% (10Y CDB at 3.6%). We hold our NDIRS 1Y/5Y curve steepeners.

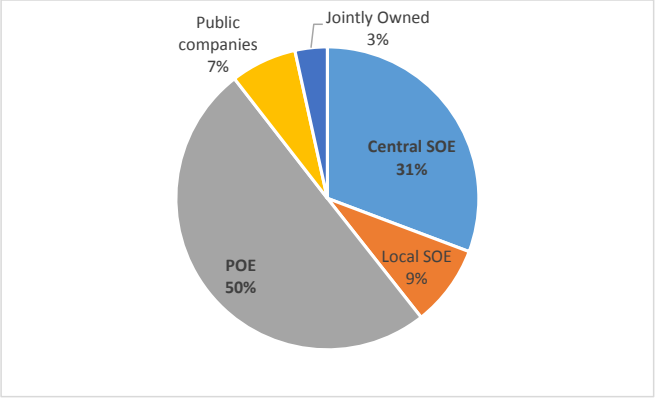
The risk to our call is a major second wave of the COVID19 pandemic domestically and globally or significant global event risks which dampen global and domestic risk sentiment.

Figure 41: Notional amount of bond defaults (RMBbn)



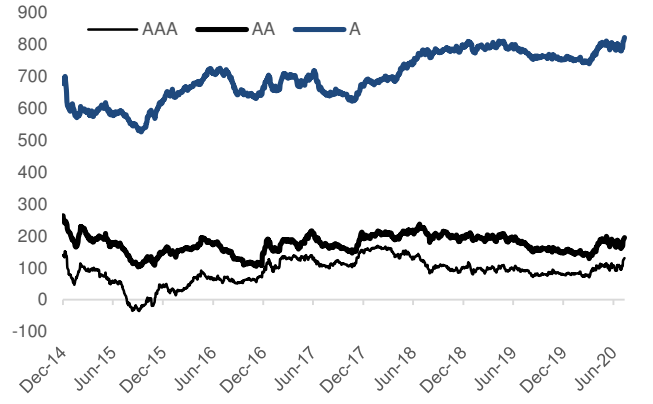
Source : Deutsche Bank, Wind

Figure 42: Breakdown of 2020 YTD defaults by notional amount by issuers



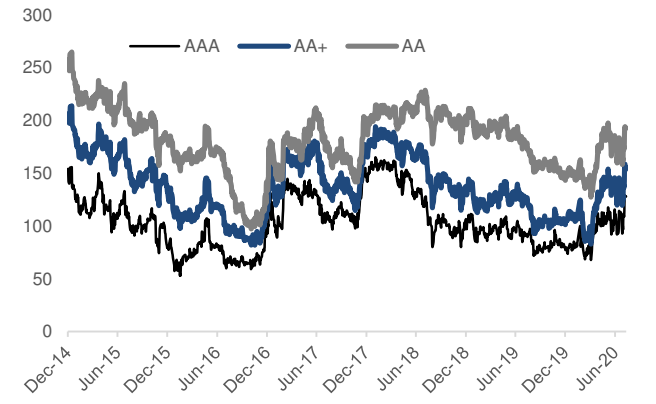
Source : Deutsche Bank, Wind

Figure 43: Credit spread of 5Y enterprise bonds (bps)



Source : Deutsche Bank, Wind

Figure 44: Credit spread of 5Y MTNs(bps)



Source : Deutsche Bank, Wind

Appendix 1

Important Disclosures

*Other information available upon request

*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors . Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at https://research.db.com/Research/Disclosures/CompanySearch. Aside from within this report, important risk and conflict disclosures can also be found at https://research.db.com/Research/Topics/Equities?topicId=RB0002. Investors are strongly encouraged to review this information before investing.

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The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Linan Liu, Yi Xiong, Perry Kojodjojo.

Additional Information

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